United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-6109

To be argued by
WILLIAM E. HEGARTY

United States Court of Appeals

FOR THE SECOND CIRCUIT

B

HUNTINGTON TOWERS, LTD. and RICHARD CAREY,

Plaintiffs-Appellants,

—against—

FRANKLIN NATIONAL BANK (in Liquidation),
FEDERAL DEPOSIT INSURANCE CORPORATION,

Defendants,

and

FEDERAL RESERVE BANK OF NEW YORK, EUROPEAN-AMERICAN BANK, and JAMES SMITH, individually and as Comptroller of the Currency,

Defendants-Appellees.

ON APPEAL FROM A JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF NEW YORK

BRIEF ON BEHALF OF DEFENDANT-APPELLEE FEDERAL RESERVE BANK OF NEW YORK

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Preliminary Statement

In May 1974, Franklin National Bank ("Franklin National"), then the nation's twentieth-largest bank with large foreign exchange commitments, was faced with a severe and well-publicized liquidity crisis. Without access to funds from the Federal Reserve System, the lender of last resort, a run on the bank which would have forced

Franklin National to close its doors was inevitable. It was entirely possible that the closing of Franklin National in these circumstances would have resulted in a bank panic of incalculable national and international dimensions.

The Comptroller of the Currency ("Comptroller"), whose satisfaction with a national bank's solvency or insolvency is by statute the determinant of whether a national bank is to be placed in receivership, determined that Franklin National was solvent although facing a massive liquidity crisis. The Comptroller so advised the Board of Governors of the Federal Reserve System ("Federal Reserve Board").

The Federal Reserve Bank of New York ("Reserve Bank") is authorized by statute to make advances to member banks precisely so as to avoid the consequences threatening Franklin National and the banking system. The Reserve Bank is required by statute to obtain collateral satisfactory to it to secure such advances. In accordance with this statutory authority and requirement, the Reserve Bank made massive collateralized advances to Franklin National beginning in May 1974.

Ultimately, in October 1974, the Comptroller became "satisfied" (the statutory term) that Franklin National was insolvent and appointed the Federal Deposit Insurance Corporation ("FDIC") as its receiver. The FDIC that day sold and transferred, with court approval as required by statute, most of the assets and liabilities of Franklin National to European American Bank, which continued the banking business of Franklin National without interruption. In its corporate capacity the FDIC assumed primary responsibility for repayment of the advances the Reserve Bank had made to Franklin National. The consequences which the precipitous closing of Franklin National's doors in May 1974 would have brought about were avoided.

Insofar as this appeal relates to the Reserve Bank, it seeks to reverse the judgment of the District Court that the

collateralized advances made by the Reserve Bank to Franklin National, as authorized and required by statute, did not constitute either an actionable tort or an unlawful preference. If the appeal were to be sustained, the statutory authority which empowers Federal Reserve Banks to make collateralized advances to member banks so as to meet such crises as was presented by Franklin National would effectively be repealed. Thus, the appeal in essence asks this Court to revise with retroactive effect the present statutory scheme for dealing with bank liquidity crises—a task which, we submit, the federal courts are not constitutionally authorized to perform. As Chief Justice Marshall stated in *Marbury* v. *Madison,* 5 U.S. (1 Cranch) 137, 170 (1803):

> "The province of the court is, solely, to decide on the rights of individuals, not to inquire how the executive, or executive officers, perform duties in which they have a discretion. Questions in their nature political, or which are, by the constitution and laws, submitted to the executive, can never be made in this court."

Questions Presented

The principal question presented by the appeal from the judgment dismissing the claim against the Reserve Bank is the following:

> Does the making by a Federal Reserve Bank of collateralized advances to a national bank, which has not been declared by the Comptroller to be insolvent, give rise to a justiciable claim that the Federal Reserve Bank has committed an actionable tort or received an unlawful preference?

Additional questions are presented:

> May the courts determine that the Comptroller "should" have determined a national bank to be in-

solvent at a date earlier than that when he became "satisfied" of its insolvency?

Is in any case the receipt by a Federal Reserve Bank of collateral as security for new monies advanced to a national bank an unlawful preference?

Were appellants legally injured by the Reserve Bank?

Counter-Statement of the Case

The Federal Banking System

The Federal Reserve System was created by Congress to prevent the monetary crises, periodic loss of public confidence in the banking system and runs on banks which had been a feature of the American economy in the Nineteenth Century and the early part of this Century.* The System consists of the Federal Reserve Board, whose members are appointed by the President with the advice and consent of the Senate, and twelve Federal Reserve Banks.

The Federal Reserve Act requires that each national banking association be a member of the System and a stockholder of the Federal Reserve Bank in its Reserve District, 12 U.S.C. § 282 (1970).** One of the principal functions of

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* The REPORT OF THE HOUSE COMMITTEE ON BANKING AND COMMERCE, H. R. REP. No. 69, 63d Cong., 1st Sess., p. 4 (1913), recommending passage of the House Bill which was enacted (with amendments) as the Federal Reserve Act of 1913, referred to the virtual suspension of specie payments by large groups of banks "[i]n 1873, 1884, 1890, 1893, 1896 and 1907, to mention the most familiar occasions . . . ."

** Member banks are required to contribute the capital of Federal Reserve Banks, 12 U.S.C. § 282, and they receive a 6% return on their investment out of the Federal Reserve Bank's earnings, with the remainder going to the United States Treasury. In 1975, 98.15% of the net earnings of the Federal Reserve Banks was paid to the Treasury, SIXTY-SECOND ANNUAL REPORT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM 353 (1975). State chartered banks can join the Federal Reserve System and take advantage of its benefits, 12 U.S.C. §§ 321 *et seq.* (1970 & Supp. V 1975).

a Federal Reserve Bank is to make loans to member banks, often on an immediate basis, in order to ensure the efficient functioning and stability of the monetary system, subject to regulations promulgated by the Federal Reserve Board, 12 U.S.C. §§ 301, 347, 347b, 347c (1970 & Supp. V 1975). The Federal Reserve Board has promulgated Regulation A, 12 C.F.R. Part 201, to regulate Federal Reserve Banks in carrying out this statutory authority. Such loans must be secured by United States Government securities, 12 U.S.C. § 347c (1970), or otherwise secured "to the satisfaction of" the Reserve Bank, 12 U.S.C. § 347b (Supp. V 1975).

The Comptroller is an official of the Department of the Treasury subject to the general directions of the Secretary of Treasury, 12 U.S.C. § 1 (1970). He is responsible for the chartering, examination and supervision of national banks, 12 U.S.C. §§ 26, 161 (1970). The statute further provides that:

> ". . . whenever the comptroller shall become satisfied of the insolvency of a national banking association, he may, after due examination of its affairs . . . appoint a receiver who shall proceed to close up such association." 12 U.S.C. § 191 (1970).

The statute also provides two objective events of insolvency (dissolution upon suit by the Comptroller for charter forfeiture or failure to pay a judgment within 30 days, 12 U.S.C. § 191), neither of which occurred here.

The FDIC acts in several capacities when a national bank is declared insolvent by the Comptroller. First—and this is its best known function—it pays depositors whose accounts it has insured. Second, the statute provides that when the Comptroller appoints a receiver for a national bank, he shall appoint the FDIC, 12 U.S.C. § 1821(c) (1970).

After the Comptroller is satisfied that a national bank is insolvent, and appoints the FDIC as receiver, the FDIC

"upon the order of a court of record of competent jurisdiction . . . may sell all the real and personal property of such association on such terms as the court shall direct . . . ." 12 U.S.C. § 192 (1970).

The Authority of Federal Reserve Banks to Make Collateralized Advances to Member Banks

The national banking system was created by legislation enacted during the Civil War. Act of June 3, 1864, ch. 106, 13 Stat. 99. After fifty years of operation, the deficiencies of this extremely individualized and uncoordinated banking system had become apparent and the call for reform was virtually universal. H.R. Rep. No. 69, 63d Cong., 1st Sess. 3 (1913). The result was enactment of the Federal Reserve Act. Act of December 23, 1913, ch. 6, 38 Stat. 251.

The report of the House Committee on Banking and Currency recommending passage of the bill which became the Federal Reserve Act, H.R. Rep. No. 69, 63d Cong., 1st Sess. (1913), discussed the "long-standing evils" and "essential defects" in the national banking system which the bill was intended to correct (H.R. Rep. No. 69, p. 3), chief among them being:

(a) "In view of the lack of any factor of unity the national banks have failed to furnish to the Nation as a whole a single and powerful system of credit." (*Id.* at 4)

(b) "[T]he country has lacked the capacity either to prevent credit disorders from breaking out locally and spreading to the centers, or to defend its own resources against the monetary demands of foreign nations or against the infection due to bad financial conditions in countries with which we stood in close relations." (*Ibid.*)

(c) "In 1873, 1884, 1890, 1893, 1896 and 1907, to mention the most familiar occasions, it has been necessary for

large groups of banks practically to suspend specie payments. * * * In spite of all that could be done, however, the public has been put to great inconvenience and loss upon such occasions, the relations of the United States with foreign countries have been embarrassed, if not brought into jeopardy, the failure of firms, corporations, and individuals has been necessitated, and the loss of wealth has been tremendous." (*Ibid.*)

(d) "In the reserve centers today banks are unable to extend the credit that they would under normal circumstances be disposed to grant, while merchants are frequently unable to get the accommodation to which they are entitled." (*Id.* at 5)

(e) "[T]he national banking system * * * fails to afford any safeguard against panics and commercial stringencies or any means of alleviating them." (*Id.* at 6)

To solve these problems, the report went on to specify the fundamental objects of the proposed legislation, which included:

> "General economy of reserves in order that such reserves might be held ready for use in protecting the banks of any section of the country and for enabling them to go on meeting their obligations instead of suspending payments, as so often in the past." (H.R. Rep. No. 69, at 11)*

In the ensuing quarter century further refinements in the system were made; we focus herein on the power of Federal Reserve Banks to make advances to member banks.

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* The fundamental purpose of the system—the maintenance of a sound banking structure on which our economic system is so heavily dependent—makes it absurd to argue, as does Huntington Towers, that it was "unethical" or a conflict of interest for, *inter alia,* the Reserve Bank to exercise the discretion given to it by Congress and thus to protect its member banks, who are its stockholders by Congressional direction.

With the Crash of 1929 and its aftermath, additional substantial changes were made in this and many other areas.

12 U.S.C. § 347—The first limited grant of authority for advances by Federal Reserve Banks to member banks on the members' notes was given in Section 13 of the Federal Reserve Act of 1916, Act of September 7, 1916, ch. 461, 39 STAT. 752.

This provision was substantially reformulated by Section 9 of the Banking Act of 1933. Act of June 16, 1933, ch. 89, § 9, 48 STAT. 180. *See* S. REP. No. 77, 73d Cong., 1st Sess. 14 (1933); H. R. REP. No. 150, 73d Cong., 1st Sess. 2 (1933). Apart from several amendments with respect to the types of collateral required as security for the notes of member banks, the provision exists today in substantially the same form in 12 U.S.C. § 347 (1970) which provides, *inter alia,*

> "Any Federal reserve bank may make advances for periods not exceeding fifteen days to its member banks on their promissory notes secured by the deposit or pledge of bonds, notes, certificates of indebtedness, or Treasury bills of the United States, or by the deposit or pledge of debentures or other such obligations of Federal intermediate credit banks which are eligible for purchase by Federal reserve banks under section 350 of this title, or by the deposit or pledge of bonds issued under the provisions of subsection (c) of section 1463 of this title; and any Federal reserve bank may make advances for periods not exceeding ninety days to its member banks on their promissory notes secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by Federal reserve banks under the provisions of this chapter, or secured by such obligations as are eligible for purchase under section 355 of this title. All such advances shall be made at rates to be established by such Federal reserve banks, such rates

to be subject to the review and determination of the Board of Governors of the Federal Reserve System."

12 U.S.C. § 347b—In response to the banking emergency that followed the Crash of 1929, Congress passed emergency legislation providing for additional temporary advances to member banks on a less restricted basis. Act of February 27, 1932, ch. 58, §§ 1-2, 47 STAT. 56.

Section 2 of the Act of February 27, 1932 added Section 10(b) of the Federal Reserve Act. This provision (47 STAT. 56-57) was intended at the time to grant the Federal Reserve Banks only temporary authority (expressly only "[u]ntil March 3, 1933, and in exceptional and exigent circumstances") to make such advances individually to smaller member banks in the absence of the kinds of collateral required in Section 13, paragraph 8 (now 12 U.S.C. § 347), although there was sentiment in Congress for a permanent grant of this authority. 75 CONG. REC. 4316 (1932).

Several extensions of this temporary authority were granted by Congress and the President. Act of February 3, 1933, ch. 34, 47 STAT. 794; Act of March 9, 1933, ch. 1, § 402, 48 STAT. 7; Proclamation No. 2076, February 16, 1934, 48 STAT. 1734. In enacting these extensions, Congress also liberalized the applicability of the provision. The Act of March 9, 1933, *supra,* eliminated the restriction on the size of member banks to which such advances could be made (48 STAT. 7). Most of the remaining restrictions were eliminated when Congress finally made Section 10(b) a permanent provision of the Federal Reserve Act.

Congress granted permanent authority for such advances in Section 204 of the Banking Act of 1935, Act of August 23, 1935, ch. 614, § 204, 49 STAT. 705, which amended Section 10(b) of the Federal Reserve Act to read as follows:

"Any Federal Reserve bank, under rules and regulations prescribed by the Board of Governors of the

Federal Reserve System, may make advances to any member bank on its time or demand notes having maturities of not more than four months and which are secured to the satisfaction of such Federal Reserve bank. Each such note shall bear interest at a rate not less than one-half of 1 per centum per annum higher than the highest discount rate in effect at such Federal Reserve bank on the date of such note."

The House report on § 206 of the original House bill, H.R. REP. No. 742, 74th Cong., 1st Sess. (1935), discussed the reasons for the amendment of Section 10(b):

"Existing limitations had to be suspended during the emergency, but this was accomplished only after they had done a great deal of harm and after many banks had failed because of a lack of assets technically eligible for obtaining accommodation at a Federal Reserve bank. Since in practice existing restrictions must be relaxed whenever they become really restrictive, it is best not to have them in the law, but to place full regulatory responsibility on the Board, which is always in session and in a position to take prompt action when it is required.

* * *

"This amendment, by removing many of the technical restrictions of the present law, will enable the Federal Reserve banks to render better service to their member banks in times of need. This will not only make membership in the Federal Reserve System much more attractive but will encourage the member banks to invest their savings deposits, which are essentially capital funds, in longer-term loans, a course that would greatly facilitate business recovery.

"This amendment will also make it possible for banks, without relaxing prudence or care, to meet local needs both for short-time and for long-time funds, and to be assured that in case of need they can

obtain advances from the Reserve banks on the basis of all their sound assets, regardless of their form or of the nature of the collateral." (pp. 10-11)

The Franklin National Bank Crisis

By mid-May 1974, it was public knowledge that the Franklin National had suffered large losses due to unauthorized foreign exchange transactions. On Sunday, May 12, 1974, George W. Mitchell, Vice Chairman of the Federal Reserve Board, announced that:

> "Working with Franklin National, the Federal Reserve Bank of New York has determined that there is a large amount of acceptable collateral available to support advances to the bank from the Federal Reserve discount window, if they are needed.
>
> "As a matter of general policy the Federal Reserve makes credit extensions to member banks, upon acceptable collateral, so long as the borrowing member bank is solvent. We are assured by the Comptroller of the Currency that Franklin National Bank is a solvent institution." (A181)*

A letter from the Acting Comptroller of the Currency to the Federal Reserve Board, dated May 10, 1974, stated:

> "[a]t the last full examination of the subject bank which terminated on March 8, 1974, the bank was found to have fairly severe credit and liquidity problems, but was adjudged to be solvent. Although the liquidity problem has subsequently become aggravated by adverse rumors circulating in the market place, to date, we have not received any information which would materially alter our March 8, 1974 conclusion that the bank is solvent. If there is any significant change in

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* This announcement was prompted by disclosures during the week which led the Securities and Exchange Commission on May 13, 1974 to suspend trading in the stock of Franklin National and of its parent holding company. 39 FED. REG. 18166 (1974).

the condition of the bank, this Office will promptly advise you." (A180-A181)

That Franklin National faced severe liquidity problems which in the circumstances made it appropriate in the Reserve Bank's judgment for it to lend, on a secured basis as mandated by statute, massive amounts to Franklin National was hardly a secret. By May 31, 1974, it was public knowledge that Franklin National's borrowings upon collateral from the Reserve Bank had risen to over one billion dollars. (*See* A165, A181)

Throughout the summer there were various efforts, well publicized, to find a solution to the liquidity problem of Franklin National and permit repayment of the Reserve Bank's loans whether by merger of Franklin National with another bank or otherwise.

Finally, the Comptroller on October 8, 1974, declared, pursuant to 12 U.S.C. § 191 (1970), that he had become satisfied that the Franklin National was insolvent, and he appointed the FDIC as receiver for the Franklin National. (A15, A166) The receiver issued a call for bids for the purchase of Franklin National's assets (pursuant to previously drafted documents) and determined that the bid by the European American was the best bid submitted.

Immediately thereafter Judge Judd, pursuant to 12 U.S.C. § 192 (1970), approved the receiver's sale of assets, finding that it appeared to be the "best solution to a serious and delicate problem." *In re Franklin National Bank,* 381 F.Supp. 1390, at 1393 (E.D.N.Y. 1974). The following morning Franklin National's doors were open, but under the name of the new owner of its banking business.

The Complaint

The two plaintiffs-appellants (collectively "Huntington Towers") are a corporation which is alleged to own and to seek to develop a parcel of real estate in Long Island, and the corporation's sole stockholder (A3, A5). The complaint

named as defendants the FDIC, James Smith, individually and as Comptroller of the Currency, the Reserve Bank, European American and Franklin National.

As a First Claim, the complaint alleged, on information and belief,* that:

> "4. On or about May 1, 1974 and continuing thereafter until October 8, 1974, Franklin National was insolvent.
>
> "5. Beginning on and after May 15, 1974, defendants Smith [the Comptroller], Federal Reserve [the Reserve Bank] and FDIC knew that Franklin National was insolvent and that it *should* have been declared insolvent and placed into liquidation proceedings pursuant to law.
>
> "6. Defendants Franklin National, Smith, Federal Reserve and FDIC entered into an illegal and improper plan to conceal the insolvency of Franklin National and to continue the said Bank in operation for a period of several months knowing that ultimately it would be declared insolvent and placed in liquidation. As part of said plan, defendant Federal Reserve made very substantial advances of funds for the purposes of maintaining the liquidity of Franklin National and for the purpose of permitting uninsured depositors to withdraw their funds from Franklin National and be replaced as creditors by defendant Federal Reserve under claim of priority. In advancing these funds, defendants arranged for Franklin National to purport to grant defendant Federal Reserve substantial amounts of Franklin National's assets as security." (A4-A5, emphasis added)

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* The basis for the "information and belief" as to these matters is not stated, despite Rule 9(b) of the FEDERAL RULES OF CIVIL PROCEDURE. This failure is by itself enough to justify affirmance of dismissal of the complaint. *Segal* v. *Gordon,* 467 F.2d 602 (2d Cir. 1972) and *Segan* v. *Dreyfus Corp.,* 513 F.2d 695 (2d Cir. 1975).

The complaint further alleged that:

"9. In November 1973, plaintiffs and Franklin National entered into an agreement pursuant to which Franklin National agreed to finance the construction of additional improvements (a second building) on the real property hereinabove referred to. Pursuant to said agreement, Franklin National had agreed to advance (and did from time to time advance) such funds as were necessary to complete construction, up to a total amount of approximately $5,000,000 against a commitment from a responsible lending institution to issue a permanent mortgage on the completed building in the said amount.

"10. Thereafter and between November 1973 and October 8, 1974 pursuant to the agreement as aforesaid, Franklin National advanced funds for the purposes hereinabove set forth in paragraph '9' and plaintiffs (i) proceeded with the construction of said building, (ii) secured the necessary commitment for a permanent mortgage and (iii) secured a major tenant for the said building. At no time did Franklin National disclose to the plaintiffs that it was insolvent and would be incapable of completing the financing as aforesaid.

"11. On or about June 14, 1974, *at the request of Franklin National made pursuant to the foregoing agreement,* plaintiffs gave Franklin National certain additional security for monies advanced and to be advanced under the construction financing agreement hereinabove referred to . . . ." (A6, emphasis added)

In September 1974, "owing to its financial condition, Franklin National became unable to advance further funds for construction" * (A7). The alleged result has been that

* In fact, as appeared from an affidavit submitted by Huntington Towers, Franklin National continued to make loans to Huntington Towers until the October receivership. (A138-A139).

construction on Huntington Towers' development came to a complete halt (A7) and Huntington Towers went into default under secured obligations to other creditors. (A8)*

Huntington Towers claimed $8,000,000 in damages under the First Claim (A8), but without any explanation of the basis therefor.

In the Second Claim (A8-A9), Huntington Towers claimed to be "general creditors" of the Franklin National, presumably on the theory that it allegedly owes Huntington Towers $8,000,000 under the First Claim. Huntington Towers alleged, again on information and belief, that the sale of assets and other arrangements approved by Judge Judd "are contrary to law and constitute a fraud on the general creditors of Franklin National." The complaint sought a declaration that the Reserve Bank "is entitled to no security interest or preference as against the plaintiffs," and an injunction against the FDIC recognizing such security interest. (A9)

The final item of the prayer for relief demonstrated what Huntington Towers thought this action was really all about. The complaint demanded that the court declare "null and void all mortgages or other security instruments, notes and guarantees given by plaintiffs to Franklin National." **

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* The complaint also alleged that after the FDIC was appointed receiver for the Franklin National and European American purchased its assets, representatives of all three assured Huntington Towers that the FDIC, European American or Franklin National (*sic*) would make further loans to them (A7), but that the FDIC and European American thereafter failed and refused to do so. (*Ibid.*) These allegations have nothing to do with the Reserve Bank.

** The word "notes" is sandwiched between the collateral documents, but it is there. Thus, the debtor would also become a creditor between the First and Second Claims, and at the end of the prayer for relief would cease even to be a debtor.

ARGUMENT

I.

The Making of Collateralized Advances by a Federal Reserve Bank to a National Bank Does Not Give Rise to a Justiciable Claim.

Huntington Towers claims that the Reserve Bank, by making advances to the Franklin National against collateral as required by statute, became liable to Huntington Towers since the liquidity provided by the advances enabled Franklin National to keep its doors open (App. Br., pp. 36-38)—and probably avoided a major bank panic.*

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* Because the severe financial difficulties of Franklin National (and the advances of the Reserve Bank to it) were public knowledge, Huntington Towers does not, and could not, claim that it was misled into believing that Franklin National was in rosy good health in June 1974 when, in accordance with its earlier agreement, Huntington Towers pledged additional collateral with Franklin National.

Even if the financial difficulties of the Franklin National had not been publicly known, Huntington Towers could not recover on any theory that the federal authorities were under a duty to disclose them. See *Davis* v. *Federal Deposit Insurance Corp.,* 369 F.Supp. 277 (D.Colo. 1974), where plaintiffs alleged that the FDIC "knew" that the financial condition of a state-chartered bank was deteriorating, but did not reveal that information to the public until the date that the FDIC closed the bank. Plaintiffs further alleged that "had the true facts been made public, they would not have deposited their money in the Bank and thus would not have sustained a loss." The Court found that the FDIC was discharging a discretionary governmental function, and held that

> "We find nothing in the statute or the case law which imposes upon the F.D.I.C. a duty to advise the general public on an insured bank's financial condition, be it good or bad. Since the F.D.I.C. was under no duty to disclose to the public its failure to do so is not actionable." 369 F.Supp. at 280.

This distinguishes the cases relied upon by Huntington Towers (App.Br., pp. 36-37) which involved the fiduciary duty of bank directors to disclose to depositors their knowledge of the insolvency of the bank.

We submit that in making collateralized advances to Franklin National, which had not been determined to be insolvent by the Comptroller, the Reserve Bank was discharging a discretionary governmental function for the precise purpose that the function was intended—to meet crises involving national banks—and that the propriety of the making of those loans is not subject to attack in this action.

The legal insufficiency of Huntington Towers' claim to the contrary is demonstrated by the "distinction" it is forced to present:

> "There is a significant difference between the [Reserve Bank] knowingly lending money to an insolvent bank and lending money to a bank that has a temporary but pressing liquidity problem." (App. Br., p. 49)

But this is precisely the kind of judgment call as to which the District Court noted that "[i]n other circumstances courts have refused to review discretionary acts of the Federal Reserve banks" (A182). The District Court went on to hold that

> "[t]he ability of Federal Reserve Banks to serve their function may be inhibited if loans to a national bank suffering liquidity problems are subject to reexamination after the event. . . . It is clear that under present statutes Franklin had the power to pledge its assets with FRB [the Reserve Bank] and that FRB had power to make the loan here involved." (A185-A186)*

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* While the District Court also based its dismissal of Huntington Towers' "tort" claim by reason of the Federal Tort Claims Act, 28 U.S.C. § 2680(h), there was actually no need to do so and such defense was not raised by the Reserve Bank. The cases cited by the District Court and discussed herein demonstrate that the discretionary activities of the Reserve Bank involved here are not subject to judicial scrutiny whether or not the jurisdictional limitations of the Federal Tort Claims Act apply to the Reserve Bank. We do not believe that this Court need go further and decide whether the activities of the Reserve Bank are generally protected by that Act.

The relevant statutes and applicable case law fully support the decision of the District Court.

Section 10(b) of the Federal Reserve Act, 12 U.S.C. § 347b (Supp. V 1975) provides, as noted above, that

> "Any Federal Reserve bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, may make advances to any member bank on its time or demand notes having maturities of not more than four months and which are secured to the satisfaction of such Federal Reserve bank. * * *"

Section 13 of the Federal Reserve Act, 12 U.S.C. § 347 (1970) further authorizes a Reserve Bank to make advances to member banks secured by specified types of obligations of the federal government or certain of its agencies held by the member banks as well as bankers' acceptances and the like eligible for rediscount.

Pursuant to these provisions, and the power given the Federal Reserve Board to issue regulations by Section 4(8) of the Act, 12 U.S.C. § 301, the Board promulgated Regulation A, 12 C.F.R. § 201.2, which provided:

> "(a) *Accommodation of credit needs of individual banks.* Extending credit to member banks to accommodate commerce, industry, and agriculture is a principal function of Reserve Banks. While open market operations and changes in member bank reserve requirements are important means of affecting the overall supply of bank reserves, the lending function of the Reserve Bank is an effective method of supplying reserves to meet the particular needs of individual member banks.
>
> "(b) *Effect on overall monetary and credit conditions.* The lending functions of the Federal Reserve System are conducted with due regard to the basic

objectives of the Employment Act of 1946 and the maintenance of a sound and orderly financial system. These basic objectives are promoted by influencing the overall volume and cost of credit through actions affecting the volume and cost of reserves to member banks. Borrowing by individual member banks, at a rate of interest adjusted from time to time in accordance with general economic and money market conditions, has a direct impact on the reserve positions of the borrowing banks and thus on their ability to meet the needs of their customers. However, the effects of such borrowing do not remain localized but have an important bearing on overall monetary and credit conditions.

"(c) *Short-term adjustment credit.* Federal Reserve credit is available on a short-term basis to a member bank, under such rules as may be prescribed, to such extent as may be appropriate to assist such bank in meeting temporary requirements for funds or to cushion more persistent outflows of funds pending an orderly adjustment of the bank's assets and liabilities.

* * *

"(e) *Emergency credit for member banks.* Federal Reserve credit is available to assist member banks in unusual or emergency circumstances such as may result from national, regional, or local difficulties or from exceptional circumstances involving only a particular member bank.* "

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* The amendment of subparagraph (e) of Regulation A by the Federal Reserve Board, effective September 25, 1974, further clarified the meaning of "exceptional circumstances" involving a particular bank:

"(e) *Other credit to member banks.* (1) In the event of unusual or emergency circumstances resulting from national, regional, or local difficulties, Federal Reserve credit beyond that contemplated under section 201.2(c) is available.

"(2) Federal Reserve credit is also available for protracted assistance where there are exceptional circumstances or prac-

The statute and Regulation A promulgated thereunder directly authorized the Reserve Bank to make collateralized advances to Franklin National based upon the Reserve Bank's best judgment regarding the presence or absence of emergency or exceptional circumstances. Many factors are involved in such a decision and, of necessity, can only be evaluated by officers of the Federal Reserve Banks in light of their expertise acquired through experience in this specialized area of banking, and their intimate knowledge of the financial situation of the economy and the national bank in question. The decision often, as was true in the case of Franklin National, must be made immediately if the bank's doors are to remain open. To hold a Federal Reserve Bank liable in a private tort action because it exercised its authorized discretion to make advances to a national bank suffering liquidity problems, would frustrate the purposes which underlie Federal Reserve credit policy —the advancement of the public interest by contributing to the greatest extent possible to economic stability and growth—and would prevent the Reserve Banks from discharging their statutory duties to member banks.

As the Federal Reserve Board has stated:

> "The Federal Reserve System has a clear responsibility to lend to member banks in both isolated and wide-

tices involving only a particular member bank. A special rate apart from rates charged for lending to member banks under other provisions of this Part may be established by Federal Reserve Banks subject to review and determination by the Board of Governors and applied to such credit. The special rate may apply to member banks borrowing for prolonged periods (such as for more than eight weeks) and in significant amounts (such as when the loan has exceeded on average the amount of the borrowing bank's required reserves) because of financial strains arising from particular circumstances or practices affecting the individual bank—including sustained deposit drains, impaired access to money market funds, or sudden deterioration in loan repayment performance. In no case should the special loan rate to member banks exceed the rate established for loans to nonmembers under 12 U.S.C. 347(c)."

> spread emergency situations. It is expected that such assistance would often have beneficial effects for the economy as a whole, but in such cases the immediate responsibility of the System is directly to the member bank. This is one of the benefits of Federal Reserve membership—paid for in a sense by the maintenance of non-earning assets in satisfaction of reserve requirements—and a basic source of confidence in the banking system." *Report of A System Committee* in Volume 1, Reappraisal of the Federal Reserve Discount Mechanism, p. 19. (Board of Governors of the Federal Reserve System, 1971)

This was precisely the rationale behind Congressional action to grant the authority to Federal Reserve Banks to make such advances to members. See H. R. Rep. No. 742, at 10-11, quoted at pages 10-11, *supra*.

It cannot be overemphasized that the federal monetary and banking system can only work as long as the authorities are free, each in their own informed discretion, to act, and to act quickly. Their decisions involve discretion in its most classic sense—the authority to act on the basis of considerations outside the area of judicial competence. The decision of a Federal Reserve Bank to advance funds against collateral to a member bank suffering from a liquidity crisis is political in the same sense as a Congressional decision to lend Federal monies to a municipality or a private corporation. One might argue—as a political matter—whether such loans were good or bad economic policy, but it would not be thought that they would give rise to a claim by a private party that "fraud" or any other legally cognizable wrong had been committed.

The courts have recognized that these policy considerations, and the Congressional scheme itself, preclude them from intruding on such sensitive areas. In *Billings Utility Co.* v. *Advisory Committee*, 135 F.2d 108 (8th Cir. 1943), a Federal Reserve Bank refused to make a loan under 12

U.S.C. § 352a(a), a section (later repealed) providing for working capital loans to businesses under "exceptional circumstances." The plaintiffs alleged that the refusal was "wilful, arbitrary, capricious," etc. and requested damages. The Court of Appeals for the Eighth Circuit affirmed a judgment for the Federal Reserve Bank, holding that:

> "[T]he power which they were exercising was discretionary. . . . As the functions which these officers must discharge are discretionary, their freedom to act upon any application for credit must be preserved and protected. . . . The conduct of the officers is, we think, subject only to the restrictions and limitations contained in the act and when they have acted within those limitations, their conduct is not subject to judicial review." (135 F.2d at 112)

This Court has recognized the need to preserve and protect the freedom of the Federal Reserve Banks to exercise the discretionary functions entrusted to them by statute. In *Raichle* v. *Federal Reserve Bank,* 34 F.2d 910 (2d Cir. 1929), plaintiff sued to enjoin the Reserve Bank from establishing certain credit restrictions and discount rates. The plaintiff there alleged that the Reserve Bank had engaged "in 'a course of conduct . . . which has had for its object and purpose an arbitrary reduction in the volume of collateral or brokers' loans' " (34 F.2d at 915). As in the instant action,

> ". . . it seems to be thought that it may be said that the acts of the bank were likely to cause damage to the plaintiff—in fact, caused such damage—and therefore gave rise to a cause of action, unless some legal justification can be shown." (*Ibid.*)

Finding that the activities in question were specifically authorized by statute, this Court, per Augustus Hand, J., affirmed dismissal of the complaint.

"In the case at bar the 'principles of policy' point the other way. It would be an unthinkable burden upon any banking system if its open market sales and discount rates were to be subject to judicial review. Indeed, the correction of discount rates by judicial decree seems almost grotesque, when we remember that conditions in the money market often change from hour to hour, and the disease would ordinarily be over long before a judicial diagnosis could be made.

* * *

"We can see no basis for the contention that it is a tort for a Federal Reserve Bank to sell its securities in the open market, to fix discount rates which are unreasonably high, or to refuse to discount eligible paper, even though its policy may be mistaken and its judgment bad. The remedy sought would make the courts, rather than the Federal Reserve Board, the supervisors of the Federal Reserve System, and would involve a cure worse than the malady. The bank, under the supervision of the board, must determine whether there is danger of financial stringency and whether the credit available for 'commerce and business' is sufficient or insufficient. If it proceeds in good faith through open market operations and control of discount rates to bring about a reduction of brokers' loans, it commits no legal wrong. A reduction of brokers' loans may best accommodate 'commerce and business.' USCA tit. 12, c. 3, § 357" (*Ibid.*)

The Court in *Raichle* also stated:

"Defendant's counsel have made a persuasive argument that upon the facts alleged the questions raised are political, and not justiciable. We have not discussed it, because without it the defendant's position seems to be unassailable." (34 F.2d at 916)

See also Bryan v. *Federal Open Market Committee,* 235 F.Supp. 877 (D. Mont. 1964), following *Raichle* and dismissing a suit against the Federal Open Market Committee (which consists of the members of the Board of Governors of the Federal Reserve System and five representatives of the Federal Reserve Banks, and which formulates policies governing open market transactions for the Federal Reserve Banks).

> "Plaintiff's brief is devoted largely to quotations from hearings before a Congressional Committee relative to the functions and operations of the Federal Open Market Committee. Plaintiff's complaint and views on the monetary policy of the United States may properly be presented to Congress. It is not the function of the judiciary to hear and determine claims of this nature. In other words, plaintiff has not presented a justiciable case or controversy." (235 F.Supp. at 882)

These cases with respect to Federal Reserve Banks are applications of the more general principle that the courts cannot review executive decisions which involve the exercise of judgment and discretion. *Marbury* v. *Madison, supra; Decatur* v. *Paulding,* 39 U.S. (14 Pet.) 497 (1840); *Spalding* v. *Vilas,* 161 U.S. 483 (1896); *Louisiana* v. *McAdoo,* 234 U.S. 627 (1914); and *Greene County Nat'l Farm Loan Ass'n* v. *Federal Land Bank,* 152 F.2d 215 (6th Cir. 1945), dismissing a suit to enjoin a federal land bank's plan for relief of national farm loan associations. The comment by the Court in *Fahey* v. *O'Melveny & Myers,* 200 F.2d 420, 472-73 (9th Cir. 1952) is particularly apt here:

> ". . . the 'determination' was a decision of a kind with which the judiciary should not be concerned, for courts have neither the aptitude nor facilities to weigh the need for such orders which in our view belong in the domain of political power and are therefore not subject to judicial intrusion or inquiry. Decisions upon which such orders rested are delicate and complex, and

> necessarily involve large elements of prophecy and to that extent are akin to the decisions discussed in Chicago & Southern Air Lines, Inc. v. Waterman S.S. Corporation, 333 U.S. 103, ...
>
> "We have to confront the fact that Congress created its own administrative agency to weigh all phases of the complex problems arising in the operation of the Home Loan Bank System and vested it with authority to use its discretion in ultimately determining in some formal manner the most suitable and desirable solution for specific problems one of which might be a readjustment of bank districts."

The dangers inherent in imposing liability upon Federal Reserve Banks which led this Court in *Raichle* to reject a "cure worse than the malady" (34 F.2d at 915) are equally apparent on this appeal. Any national bank that happens to be faced with a lack of liquid funds on a particular day, and thus cannot meet its clearings, may be forced to close its doors unless it can obtain an advance from a Reserve Bank. A Federal Reserve Bank must be free to rely on its reasoned judgment in deciding whether to make advances as authorized by the Federal Reserve Act and Regulation A. Once it has determined that an advance of funds is called for, the Act mandates that the Federal Reserve Bank obtain an adequate security interest in acceptable collateral possessed by the member bank.

If a Federal Reserve Bank must additionally consider the possibility that its making of collateralized advances will become subject to litigious challenge by undefined groups of third parties, the Federal Reserve System and the Federal Reserve Banks will be precluded from the discharge of their statutory functions and discretion. The member banks will be deprived of one of the basic benefits of membership in the Federal Reserve System. The public at large will be back to the days of bank panics which the Federal Reserve System was designed to prevent.

The charges of Huntington Towers against the Reserve Bank were that, in accordance with the discretionary au-

thority granted it by statute and regulation, it rendered emergency financial assistance to a member bank prior to the time when the Comptroller decided to exercise his statutory discretion to declare it insolvent. The dispute is not with the Reserve Bank, with the Comptroller, with the FDIC or, for that matter, with any "plan" among them, but rather with the legislation governing national banks, and Huntington Towers' recourse, if any, lies in the legislative and not the judicial process.

It would invite financial chaos for the courts to intrude upon the determination of the Comptroller of whether or not a national bank is insolvent or the decision of the Reserve Bank to advance funds to keep a national bank from closing its doors prior to a determination of insolvency by the Comptroller. The existence and viability of financial institutions depend, in a most crucial manner, upon continued public confidence. When the public loses confidence in a bank, depositors will cause a run on the bank, which will rapidly lose its liquidity, preventing it from honoring checks drawn on its accounts, and thus threatening the credibility of other banks. The federal regulatory scheme is carefully designed to reduce the risk of such public panics—the Federal Reserve Banks act as lenders of last resort to assist banks with problems of maintaining liquidity, the FDIC insures deposits and the Comptroller decides when a bank has reached the point where there is no alternative but a receiver. This complex mechanism cannot function if the decisions of the regulatory authorities to act or not to act are subject to attack in private litigation, and in particular, if the courts undertake to decide whether and when the Comptroller should be "satisfied" that a national bank is insolvent, or whether and when a Reserve Bank may lend funds to a troubled national bank.*

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* For all of Huntington Towers' references to the Subcommittee (Chaired by Hon. Benjamin S. Rosenthal of Queens) of the House Committee on Government Operations, its Report's only recommen-

This was one of the thrusts of the Court's opinion in *Securities Investor Protection Corp.* v. *Barbour,* 421 U.S. 412 (1975), per Mr. Justice Marshall, holding that the customers of a brokerage firm could not sue to compel the Securities Investor Protection Corporation ("SIPC") to grant its protection to the brokerage firm. The Court noted the special expertise, and range of alternatives, employed by SIPC, which generally defers seeking a receiver until there are no realistic alternatives.

> "By this policy, the SIPC avoids unnecessarily engendering the costs of precipitate liquidations—the costs not only of administering the liquidation, but also of customer illiquidity and additional loss of confidence in the capital markets—without sacrifice of any customer protection that may ultimately prove necessary. A customer, by contrast, cannot be expected to consider, or have adequate information to consider, these public interests in timing his decision to apply to the courts.
>
> "The respondent in this case does not, of course, claim any right to make the decision that a firm should be liquidated; the Act makes that a judicial decision. He seeks only the right to ask the District Court to make that decision when both SIPC and the SEC have refused or simply failed to do so. In practical effect, however, the difference is slight. Except with respect to the solidest of houses, *the mere filing of an action predicated upon allegations of financial insecurity might often prove fatal.* Other customers could not be expected to leave their cash and securi-

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dation of an even possible application to the Reserve Bank is that the "bank regulatory agencies should undertake immediately the establishment of special interagency procedures for dealing with or making loans to troubled major money-market banks and for notifying the relevant committees of the Congress with respect to such situations", and that the General Accounting Office should review the effectiveness of these agencies, H. R. Rep. No. 94-1669, 94th Cong., 2d Sess. 9 (1976).

> ties on deposit, nor other brokers to initiate new transactions that the firm might not be able to cover when due if a receiver is appointed, nor would suppliers be likely to continue dealing with such a firm. These consequences are too grave, and when unnecessary, too inimical to the purposes of the Act, for the Court to impute to Congress an intent to grant to every member of the investing public control over their occurrence. On the contrary, they seem to be the very sorts of considerations that motivated Congress to put SIPC in the hands of a public board of directors, responsible to an agency experienced in regulation of the securities markets." (421 U.S. at 422-23, emphasis added)

The Reserve Bank had the discretion to advance funds to the Franklin National against collateral, and the exercise of such discretionary authority is not a matter which can be challenged by private litigation in the courts.

II.

The Judgment of the Comptroller With Respect to the Solvency of a National Bank Is Not Subject to Judicial Review.

Also critical to Huntington Towers' claim against the Reserve Bank is the challenge made against the Comptroller's exercise of his discretion under 12 U.S.C. § 191 (1970) to determine the solvency of a national bank. The District Court held:

> "The language of 12 U.S.C. § 191 is that the Comptroller 'may' appoint a receiver when he is satisfied of the insolvency of a national bank. The timing of a receivership is a sensitive matter, on which the Comptroller's discretion should not be hampered by fears of judicial second-guessing." (A191)

While this issue may more properly be discussed in detail by the Comptroller, we stress that the decision of the District Court is in accord with a uniform and unbroken line of authority.*

Thus, the basic assumption on which the argument of Huntington Towers' case is premised—that the courts can declare that the Comptroller was wrong, and indeed guilty of fraud, in failing to declare the Franklin National insolvent on May 15, 1974, which allegedly he "should" have done—is totally unfounded. With the collapse of this assumption, Huntington Towers' argument against the Reserve Bank also collapses.

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* *Kennedy* v. *Gibson*, 75 U.S. (8 Wall.) 498 (1869); *Casey* v. *Galli*, 94 U.S. 673 (1876); *Easton* v. *Iowa*, 188 U.S. 220 (1903); *DeWeese* v. *Smith*, 106 F. 438 (8th Cir. 1901), *aff'd w/o opinion sub nom. Smith* v. *Brown*, 187 U.S. 637 (1902); *Liberty National Bank* v. *McIntosh*, 16 F.2d 906 (4th Cir.), *cert. dism'd*, 273 U.S. 783 (1927); *B.V. Emery & Co.* v. *Wilkinson*, 72 F.2d 10 (10th Cir. 1934); *United States Savings Bank* v. *Morgenthau*, 85 F.2d 811 (D.C.Cir.), *cert. denied*, 299 U.S. 605 (1936); *United States National Bank* v. *Pole*, 2 F.Supp. 153 (D.Ore. 1932); *O'Connor* v. *Bankers Trust Co.*, 159 Misc. 920, 289 N.Y.S. 252 (Sup.Ct. N.Y.Co. 1936), *aff'd*, 253 App.Div. 714, 1 N.Y.S.2d 641 (1st Dep't 1937), *aff'd*, 278 N.Y. 649, 16 N.E.2d 302 (1938); *cf. In re Conservatorship of Wellsville National Bank*, 407 F.2d 223 (3d Cir.), *cert. denied*, 396 U.S. 832 (1969).

To take an extreme case, in *United States Savings Bank* v. *Morgenthau, supra*, the Court held that the presumption of correctness of the Comptroller's decision was not overcome by the allegation (although its accuracy was necessarily conceded for purposes of the motion to dismiss) that the Comptroller's decision was "arbitrary, wanton and malicious".

Representative Rosenthal's Subcommittee Report notes that "[b]oth the legislative history and the interpretive case law indicate that the purpose of the law is to extend the power of the Comptroller to appoint receivers, not impose upon him a legal duty to do so". H. R. REP. No. 94-1669, 94th Cong., 2d Sess. (1976), p. 40.

III.

The Receipt of Collateral by the Reserve Bank for Its Advances to Franklin National Was Not an Unlawful Preference.

Once the Reserve Bank determined to exercise its discretionary authority to advance funds to Franklin National, the Reserve Bank was obligated by law to obtain collateral satisfactory to it for such advances. To void the lien of the Reserve Bank as an unlawful preference would as surely repeal the Reserve Bank's authority to make the advances as would a holding that the advances themselves were tortious.

The attack upon the collateral received by the Reserve Bank falls for other reasons as well. The Reserve Bank received security interests only for "new money" it loaned the Franklin National. But a preference is created only when a creditor receives security in respect of an antecedent debt, and does so in contemplation of the debtor's insolvency. Receipt of a security interest in connection with a new loan is simply not a preference.*

12 U.S.C. § 91 (1970) renders void certain transfers of the assets of a national bank, and that is the only federal statute under which the giving of security for a loan to a national bank may be avoided. *Schumacher* v. *Eastern Bank & Trust Co.*, 52 F.2d 925, 928 (4th Cir. 1931).** The

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* Huntington Towers asks the Court to "take note that the [Reserve Bank] was advancing large sums of money on a daily basis for many months prior to the week of May 13, 1974 [and] bankrolling the speculations of FNB in 1973-74 in the foreign exchange markets * * *." (App. Br., p. 47). This statement is unsupported as a matter of record and in point of fact is simply wrong. Huntington Towers must be confusing advances by the Reserve Bank with so-called "federal funds" or excess reserves of other banks which they loaned to Franklin National, usually on an unsecured overnight basis.

** The Bankruptcy Act by its express terms is not applicable to banking corporations. 11 U.S.C. § 22. Huntington Towers' appeal to the "spirit" of the Bankruptcy Act (App. Br., p. 42) is symptomatic of the fallacy of its approach.

law is clear—and has been clear for many years—that Section 91 has no application if the collateral is given when the debt is created and in order to secure the debt. *Armstrong* v. *Chemical Nat'l Bank,* 41 F. 234 (C.C.S. D.N.Y. 1890); *Lucas* v. *Federal Reserve Bank,* 59 F.2d 617 (4th Cir. 1932). Indeed, to avoid the taking of security to secure a new loan would be to prefer the other antecedent creditors who would thus be benefited by the loan while forcing the new lender to give up the security which induced him to extend the loan. *Stapylton* v. *Stockton,* 91 F. 326 (5th Cir. 1899).

Moreover, the prohibitions of Section 91 apply only when the collateral is received "after the commission of an act of insolvency or in contemplation thereof." Plainly, the secured interests in question did not come into being after "the commission of an act of insolvency." Notwithstanding Huntington Towers' allegation that the Franklin National was insolvent as of May 1, 1974, it also alleged that "until it was declared insolvent, Franklin National continued to conduct business and deal with customers. . . ." (A5) Indeed, Huntington Towers admits that Franklin National "continued to advance funds from time to time for the construction of [Huntington Towers'] building until October 8, 1974. . . ." (App. Br., p. 3).* There is simply no

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Franklin National did not at any time present an ordinary commercial bankruptcy. Congress has established a particular system for dealing with the liquidity problems of national banks and, if it eventuates, the liquidation of national banks. The Comptroller is charged with determining when the insolvency of a national bank should or is to be declared.

* To the extent that Huntington Towers is able to prove its claim against Franklin National, and the FDIC as its receiver, that Franklin National breached a contract to provide construction financing, the Court below allowed Huntington Towers to proceed. Since there is no allegation that the Reserve Bank did anything with respect to the refusal to continue to advance funds for Huntington Towers' construction project, this claim provides no basis, as the District Court held, for continuing the action with respect to the Reserve Bank.

basis for the argument that the collateral was received after the "commission of an act of insolvency."

That the collateral was not received by the Reserve Bank "in contemplation of" insolvency is demonstrated by the opinion of the District Court. Since the relevant portion of the opinion is so plainly dispositive of Huntington Towers' argument, we believe quotation therefrom is warranted:

> "Even if 12 U.S.C. § 91 applies to loans from FRB to a member bank, it would be necessary to determine first whether the liens were given 'in contemplation' of insolvency, and second whether they were given 'with a view to prevent the application of [Franklin's] assets in the manner prescribed by' the National Bank act 'or with a view to the preference of one creditor to another. . . .'
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> * * *
>
> "12 U.S.C. § 347 permits advances to member banks for periods not exceeding 15 days on promissory notes secured by pledge of United States Treasury indebtedness; and 12 U.S.C. § 347(b) provides [for advances by any Reserve Bank on notes having maturities of not more than four months and which are secured to the satisfaction of the Reserve Bank.] . . .
>
> "Franklin's notes to FRB were for the most part for only one day. There is no evidence that any were for four months. Continuance of short-term loans for over four months does not violate the statutory limitations against notes 'having maturities of not more than four months.'
>
> "It is not claimed by FRB [the Reserve Bank] that § 347(b) repealed § 91; but the two sections should be read in relation to each other, and to the general rule that a pledge of collateral for new money does not constitute a preference. *Lucas* v. *Federal Reserve Bank*, 59 F.2d 617, 621 (4th Cir. 1932). The Federal Reserve

banks, as lenders of last resort to their member banks, are given authority to respond to problems which affect individual banks and the banking community as a whole.

* * *

"The ability of Federal Reserve banks to serve their function may be inhibited if loans to a national bank suffering liquidity problems are subject to reexamination after the event, on the basis of court determinations of insolvency or the likelihood of insolvency at the time emergency action was taken.

* * *

"The loans to Franklin by FRB served at least three purposes, not connected with any intent to prefer creditors: First to buy time within which to find a solution to Franklin's problems, second to cushion the impact on the economy which might be anticipated from the failure of a major bank, and third to stave off a liquidity problem which would interfere with adequate study of the Franklin situation.

* * *

"It is clear that under present statutes Franklin had power to pledge its assets with FRB and that FRB had power to make the loan here involved." (A183-186, emphasis added.)*

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* The quoted passage constitutes an alternative holding by the District Court with respect to the Reserve Bank's lien. The Court's other rationale was that the Reserve Bank had "released its lien to EAB with respect to the assets purchased by or transferred to it, and to the FDIC as corporation with respect to the remaining assets." (A183) Under the Agreement of Assumption of Indebtedness, entered into by the Reserve Bank with the FDIC as Receiver of Franklin National and as Corporation (Ex. C. to Petition of the FDIC, *In the Matter of the Liquidation of the Franklin National Bank*) which was approved by the Court on October 8, 1974, the Reserve Bank released its security interest in the assets purchased by European American and agreed to release automatically its security interest in remaining assets upon collection. sale, transfer

Huntington Towers' reliance on *Roberts* v. *Hill,* 24 F.571 (C.C.D.Vt. 1885) (App. Br., p. 45) is unavailing. The transaction there voided involved the granting of security to a depositor for payment of his deposit, which was not only for an antecedent debt, but was beyond the powers of a national bank. That it is beyond the powers of a national bank to pledge its assets to secure deposits by a private person is also the holding of *Texas & Pacific Ry.* v. *Pottorff,* 291 U.S. 245 (1934).

But, Huntington Towers complained here about loans by the Reserve Bank, secured by assets of Franklin National satisfactory to the Reserve Bank as required by the statute. The Court in *Pottorff* expressly distinguished the pledge of assets by a national bank to secure a loan to it, which is within its statutory powers, from the securing of deposits:

> "The difference between deposits and loans is fundamental and far-reaching. The amount of the deposits is commonly accepted as a measure of the bank's success, an increase of deposits as evidence of increased prosperity. The depositor does not think of himself as lending money to the bank. * * * Often the loan is made in the hope of averting insolvency. Loans made by one bank to another commonly involve a pledge of assets, since only upon such a condition is the transaction possible. *Wyman* v. *Wallace,* [201 U.S. 230 (1906)]." (291 U.S. at 259-60; footnotes omitted)

The *Wyman* case, cited with approval in *Pottorff* held that secured notes issued by a national bank which was

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or other act of liquidation thereof by the FDIC as Corporation. The Reserve Bank further agreed to look primarily to the FDIC in its corporate capacity for repayment of the remaining indebtedness of Franklin for Reserve Bank advances. Therefore, the District Court was correct in its understanding that, on this ground as well, there was no basis for retaining the Reserve Bank as a defendant.

unable to pay maturing deposits were valid in the face of the argument that the National Bank Act, and more particularly the predecessor of 12 U.S.C. § 91 (1970), precluded such a transaction. As the Court stated:

> "The question, therefore, is, whether a national bank, finding itself embarrassed, with a large amount of assets, much in excess of its obligations, yet without the cash to make payment of those which are due and urgent, can borrow to meet those pressing demands. A very natural answer is, why not? It is not borrowing money to engage in a new business. It simply exchanges one creditor for others. There may be wisdom in consolidating all its debts into the hands of one person. At least such a consolidation cannot be pronounced beyond its powers. When time is obtained by the new indebtedness (in this case a year) it gives the borrowing bank and its officers and stockholders time to consider and determine the wisdom of attempting a further prosecution of business. In the case of an individual it would be a legitimate and often a wise transaction. It is not in terms prohibited by the national banking act." (201 U.S. at 243)

Other cases which recognize that it is entirely proper, and indeed desirable, for one bank to lend assistance to another bank in financial difficulties include *Harris* v. *Briggs*, 264 F. 726 (8th Cir. 1920); *Nakdimen* v. *First National Bank*, 177 Ark. 303, 6 S.W.2d 505 (1928); *Candor* v. *Mercer County State Bank*, 257 Ill. App. 192 (1930).

Thus, considerations of justiciability aside, the collateral received by the Reserve Bank from Franklin National was not an unlawful preference.

IV.

Huntington Towers Suffered No Legal Injury.

Huntington Towers premised its action at least as against the Reserve Bank upon the allegation that on June 14, 1974 (after Franklin National allegedly "should" have been declared insolvent) Huntington Towers gave additional security to Franklin National "at the request of Franklin National made pursuant to the [alleged November 1973 construction financing between Huntington Towers and Franklin National] agreement" (A6).*

The only decision which we have found which even comes close to such a premise for an action is *Dwelle-Kaiser Co. v. Aetna Casualty & Surety Co.*, 241 N.Y. 464, 150 N.E. 517 (1926). That decision demonstrates two points—that no cause of action exists, and that Huntington Towers has not been legally injured.

The Schaeffer Construction Company had a contract with the City of Syracuse to build a public school. Aetna was a surety on a bond guaranteeing Schaeffer's performance. Dwelle-Kaiser had a subcontract from Schaeffer to furnish glass for the schoolhouse. In performing its work, Schaeffer became insolvent and the money coming in from the city was insufficient to pay for completion of the work. Allegedly Aetna, knowing of Schaeffer's insolvency, took control of Schaeffer, had Schaeffer direct Dwelle-Kaiser to complete its subcontract, and received all monies due Schaeffer.

The conduct of Aetna was allegedly pursued with the intent and purpose of causing the contract to build the

* Alleged breaches by either Franklin National or European American, which occurred after Franklin National had been placed in receivership on October 8, 1974, of agreements to provide financing have nothing to do with the advances made by the Reserve Bank prior to that date.

schoolhouse to be completed without payment to Dwelle-Kaiser for the glass work, and to save Aetna harmless from its obligation on the bond.

In characterizing the substance of the complaint, the Court noted that:

> "The gist of the entire cause set up in the complaint is that the plaintiff went ahead with its contract thinking the construction company was solvent when it was not, and that the surety company was guilty of wrongdoing in taking an assignment to protect itself without informing the plaintiff of the insolvency of the construction company." (241 N.Y. at 468, 150 N.E. at 5[illegible]8)

The Court held that the complaint failed to state a cause of action:

> "The position of the surety company in this respect is no different than that of the Schaeffer Construction Company. What were the relative duties of the contractor and its sub-contractor in case of insolvency? *There was no duty upon the part of the contractor to reveal its insolvency, as that fact would not have relieved the sub-contractor from performing its contract.* The terms of the sub-contract are not alleged in the complaint, but if credit were to be given to the contractor for the glass work, the sub-contractor, upon learning of the insolvency could have demanded cash payment. It did not relieve the sub-contractor, however, from the duty of furnishing the material and labor contracted for. There is no allegation in the complaint that the plaintiff demanded cash or was deceived by anything that the parties did into waiving this right. The allegations amount to this:
>
> "The plaintiff performed its contract and furnished the glass work relying upon the solvency of the Schaeffer Construction Company. Later it found out that

the company was insolvent and that the surety company had finished the work through its agents and had taken an assignment of the moneys from the city of Syracuse on the contract to reimburse it for advances made. It is alleged that the insurance company took the assignment and finished the work with intent to get the plaintiff's property without paying for it. What the surety company did, it had a right to do, and what the plaintiff did it was already under obligation and contract to do." (241 N.Y. at 468-69, 150 N.E. at 518, emphasis added)

See also *Dopp* v. *Franklin Nat'l Bank,* 461 F.2d 873, 880 n.16 (2d Cir. 1972) ("one does not rely on a representation to his detriment . . . in performing a legal obligation"); *Ryan* v. *J. Walter Thompson Co.,* 453 F.2d 444, 447 (2d Cir. 1971), *cert. denied,* 406 U.S. 907 (1972).

The facts of the instant case fit squarely within the *Dwelle-Kaiser* rule. It is apparent on the face of the complaint that what Huntington Towers did—allegedly "relying in good faith on Franklin National's continued ability to perform its banking function" (Cpt. ¶ 7, A5)—Huntington Towers was "already under obligation and contract to do." (241 N.Y. at 469, 150 N.E. at 518)*

To be sure, Huntington Towers alleged that it "never would have given such security if they had known that Franklin National was then insolvent" (Cpt. ¶ 12(a), A6-

* The District Court, erroneously we submit, conjured up the possibility that consistent with the contract Huntington Towers might have delivered its additional security in installments (A174). But even without the allegation that the giving of additional security was pursuant to the previous construction financing agreement, one may safely assume that Huntington Towers would not have put up additional security unless it had been required to do so. Businessmen do not voluntarily mortgage their assets, particularly real estate developers who traditionally are heavily financed. The unlikelihood of a pledge other than as required by contract is emphasized by the sorry state of the real estate market in the fall of 1974.

A7), but that is simply an allegation that Huntington Towers would have attempted to back out of its agreement with Franklin National. In *Dwelle-Kaiser Co.* v. *Aetna Co., supra,* the Court of Appeals held that plaintiff was not relieved of its contractual obligations by Schaeffer's insolvency, and accordingly it was not damaged by fulfilling those obligations. "Mere insolvency of one of the parties to a contract does not relieve the other party from performance thereof. . . ." (241 N.Y. at 469, 150 N.E. at 519) See also 6 S. WILLISTON, CONTRACTS § 880 (3d ed. 1962).

Huntington Towers' cause is not aided by broad allegations that it was misled by the conduct of the Reserve Bank in making advances to Franklin National. As noted in *Dwelle-Kaiser, supra,* such advances cannot be deemed wrongful where "[w]hat the surety company did, it had a right to do. . . ." (241 N.Y. at 469, 150 N.E. at 518) Here, the Reserve Bank did not only what it had a right to do, but what Congress intended that it do.

CONCLUSION

For all of the foregoing reasons, it is submitted that the judgment dismissing the complaint as against the Reserve Bank should be affirmed.

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Respectfully submitted,

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STATUTORY APPENDIX

Statutory Appendix

12 U.S.C. § 91 (1970):

Transfers by bank and other acts in contemplation of insolvency.

All transfers of the notes, bonds, bills of exchange, or other evidences of debt owing to any national banking association, or of deposits to its credit; all assignments of mortgages, sureties on real estate, or of judgments or decrees in its favor; all deposits of money, bullion, or other valuable thing for its use, or for the use of any of its shareholders or creditors; and all payments of money to either, made after the commission of an act of insolvency, or in contemplation thereof, made with a view to prevent the application of its assets in the manner prescribed by this chapter, or with a view to the preference of one creditor to another, except in payment of its circulating notes, shall be utterly null and void; and no attachment, injunction, or execution, shall be issued against such association or its property before final judgment in any suit, action, or proceeding, in any State, county, or municipal court.

12 U.S.C. § 191 (1970):

General grounds for appointment of receiver.

Whenever any national banking association shall be dissolved, and its rights, privileges, and franchises declared forfeited, as prescribed in section 93 of this title, or whenever any creditor of any national banking association shall have obtained a judgment against it in any court of record, and made application, accompanied by a certificate from the clerk of the court stating that such judgment has been rendered and has remained unpaid for the space of thirty days, or whenever the comptroller shall become satisfied of the insolvency of a national banking association, he may,

after due examination of its affairs, in either case, appoint a receiver who shall proceed to close up such association.

12 U.S.C. § 192 (1970):

Default in payment of circulating notes.

On becoming satisfied, as specified in sections 131 and 132 of this title, that any association has refused to pay its circulating notes as therein mentioned, and is in default, the Comptroller of the Currency may forthwith appoint a receiver, and require of him such bond and security as he deems proper. Such receiver, under the direction of the comptroller, shall take possession of the books, records, and assets of every description of such association, collect all debts, dues, and claims belonging to it, and, upon the order of a court of record of competent jurisdiction, may sell or compound all bad or doubtful debts, and, on a like order, may sell all the real and personal property of such association, on such terms as the court shall direct. Such receiver shall pay over all money so made to the Treasurer of the United States subject to the order of the Comptroller and also make report to the Comptroller of all his acts and proceedings.

Provided, That the Comptroller may, if he deems proper, deposit any of the money so made in any regular Government depositary, or in any State or national bank either of the city or town in which the insolvent bank was located or of a city or town as adjacent thereto as practicable; if such deposit is made he shall require the depositary to deposit United States bonds or other satisfactory securities with the Treasurer of the United States for the safe-keeping and prompt payment of the money so deposited: *Provided,* That no security in the form of deposit of United States bonds, or otherwise, shall be required in the case of such parts of the deposits as are insured under section 264 of this title. Such depositary shall pay upon such money

interest at such rate as the Comptroller may prescribe, not less, however, than 2 per centum per annum upon the average monthly amount of such deposits.

12 U.S.C. § 347 (1970):

Advances to member banks on their notes.

Any Federal reserve bank may make advances for periods not exceeding fifteen days to its member banks on their promissory notes secured by the deposit or pledge of bonds, notes, certificates of indebtedness, or Treasury bills of the United States, or by the deposit or pledge of debentures or other such obligations of Federal intermediate credit banks which are eligible for purchase by Federal reserve banks under section 350 of this title, or by the deposit or pledge of bonds issued under the provisions of subsection (c) of section 1463 of this title; and any Federal reserve bank may make advances for periods not exceeding ninety days to its member banks on their promissory notes secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by Federal reserve banks under the provisions of this chapter or secured by such obligations as are eligible for purchase under section 355 of this title. All such advances shall be made at rates to be established by such Federal reserve banks, such rates to be subject to the review and determination of the Board of Governors of the Federal Reserve System. If any member bank to which any such advance has been made shall, during the life or continuance of such advance, and despite an official warning of the reserve bank of the district or of the Board of Governors of the Federal Reserve System to the contrary, increase its outstanding loans secured by collateral in the form of stocks, bonds, debentures, or other such obligations, or loans made to members of any organized stock exchange,

investment house, or dealer in securities, upon any obligation, note, or bill, secured or unsecured, for the purpose of purchasing and/or carrying stocks, bonds, or other investment securities (except obligations of the United States) such advance shall be deemed immediately due and payable, and such member bank shall be ineligible as a borrower at the reserve bank of the district under the provisions of this section for such period as the Board of Governors of the Federal Reserve System shall determine: *Provided,* That no temporary carrying or clearance loans made solely for the purpose of facilitating the purchase or delivery of securities offered for public subscription shall be included in the loans referred to in this section.

12 U.S.C. § 347b (Supp. V 1975):

Advances to individual member banks on time or demand notes; maturities; interest.

Any Federal Reserve bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, may make advances to any member bank on its time or demand notes having maturities of not more than four months and which are secured to the satisfaction of such Federal Reserve bank. Each such note shall bear interest at a rate not less than one-half of 1 per centum per annum higher than the highest discount rate in effect at such Federal Reserve Bank on the date of such note. Notwithstanding the foregoing, any Federal Reserve bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, may make advances to any member bank on its time notes having such maturities as the Board may prescribe and which are secured by mortgage loans covering a one-to-four family residence. Such advances shall bear interest at a rate equal to the lowest discount rate in effect at such Federal Reserve bank on the date of such note.